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SUBJECT: ECONOMIC GOALS OF JAPAN'S 164TH DIET SESSION

REF: A. REF A: TOKYO 675

[1](#)B. REF B: TOKYO 465

[1](#)1. (SBU) Summary. Prime Minister Koizumi has labeled this 150 day session the &administrative reform8 Diet to emphasize his continuing commitment toward the structural reform of Japan's economy. Important economic bills this session include an administrative reform bill -- to be submitted by the Cabinet Office after the passage of the budget -- a tax bill, health care reforms, revisions to tender offer bid (TOB) rules, some small changes in agricultural subsidies, amendments to the Town Planning Laws, and others. For a discussion of the budget, administrative reform, and the tax bills please see paragraphs 2-6. Bills involving health care are discussed in paragraphs 7-9. Corporate bills and amendments to agricultural subsidies can be found in paragraphs 10-11. The revision to the Town Planning Laws is described in paragraph 12. An examination of pending employment laws affecting women and training begins in paragraph 13-15. Additional bills, agreements, and treaties are examined in paragraphs 16-22 while one important omission -- an amendment to Company Law Article 821 -- is discussed in paragraph 23. See Ref A for a readout on how Diet dynamics might affect this legislative agenda. End Summary.

Fiscal 2006 Budget

[1](#)2. (SBU) Like most years, this Diet ordinary session began with deliberations on a supplementary budget for the current fiscal year. On February 3 the Diet passed a 4.52-trillion-yen (USD 38.6 billion) supplementary budget for JFY 2005. This budget set aside 180 billion yen (USD 1.5 billion) for asbestos-related expenditures. Of this, 38 billion yen (USD 325 million) was earmarked to compensate victims from asbestos-related diseases whose medical bills were not covered by existing workman's compensation (such as residents living near asbestos-dispersing facilities, and family members of employees at asbestos factories). Yen 141 billion (USD 1.2 billion) was allotted to remove asbestos from schools, hospitals and public buildings. The Diet will now begin deliberations on the fiscal 2006 budget, which was approved by the Cabinet on December 24 and stands at 79.7 trillion yen (USD 681 billion), 3 percent less than the one in fiscal 2005. The budget demonstrates improved conditions

stemming from the recovering economy. The primary balance deficit is projected at 2.2 percent of GDP, a 0.9-point improvement on the year. The bond to cover the budget deficit is 30.0 trillion yen (USD 259 billion), the lowest level in the past four years. The fiscal crisis, however, still lingers with expected outstanding government bonds of 541.8 trillion yen (USD 4.63 trillion) at the end of fiscal 2006, 5.3 trillion yen (USD 45 billion) more than at the end of fiscal 2005.

Administrative reform

13. (SBU) The administrative reform bill provides a general framework for reform that should prevent the restructuring achieved thus far from stalling or moving backwards after Prime Minister Koizumi leaves office in September. In addition, Koizumi has identified the consolidation of the eight government-affiliated financial institutions, included in the administrative reform bill, as his next goal after postal privatization. Although the details have yet to be determined, we expect the administrative reform bill to be an assortment of basic policies to downsize the government including a second round of government restructuring, after the 2001 makeover of ministries and agencies launched by then Prime Minister Ryutaro Hashimoto. It also may contain plans for a new headquarters to facilitate administrative reform and possibly a new Cabinet member committee to coordinate with the Council of Economic and Fiscal Policy (CEFP) to accelerate reform. Some of the measures to achieve a slimmer, more efficient administration are:

a) Streamlining of independent administrative institutions and other government-affiliated corporate entities, including the loss of public servant status for most executives and employees.

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b) Streamlining of Special Accounts -- rumored to hold even more superfluous projects than the General Accounts -- by decreasing the number to half or one-third from the existing 31 accounts within five years. Other recommendations include consolidating five accounts for road improvements, flood control, port improvements and other public work projects into a single category.

c) Trimming of the central and local government work force by 5 percent and 4.6 percent respectively over the next five years (FY06-10) through attrition and retirement, outsourcing practices to private entities and reducing the number of the unnecessary practices.

d) Streamlining the number of independent administrative institutions and other government affiliated corporate entities from 56 to 42, while also changing the stature of most of the executives and employees to non public servants.

e) Consolidation or privatization of eight government-affiliated financial institutions. Current plans are to merge five institutions -- the Japan Finance Corporation for Small and Medium Enterprise, the National Life Finance Corp., Okinawa Development Finance Corporation, and the Agriculture, Forestry and Fisheries Finance Corporation and the section offering international banking services at the Japan Bank of International Cooperation (JBIC) -- into a single entity. As of this writing, the rumor is that the overseas AID operations at JBIC will be transferred to the Japan International Cooperation Agency. The Development Bank of Japan and Shoko Chukin Bank will be fully privatized and transferred to two separate stock companies and the Japan Finance Corp. for Municipal Enterprises will be transferred to municipalities.

2006 Tax Reform Legislation

14. (SBU) This year's tax reform legislation will result in an effective tax hike of over 2 trillion yen (over USD 16 billion). It reflects a fiscal consolidation necessary to sustain long-term economic growth. Some commentators have warned that increasing taxes too quickly could stall the recovery. As usual, the tax legislation will be based on the

November 2005 recommendations of the Government Tax Committee, an advisory body to the Prime Minister, with some refinements from the LDP tax committee led by former Minister of State for Financial Services Hakuo Yanagisawa. The proposals include tax hikes for both individuals and corporations. Last year's tax legislation reduced the 1999 Obuchi special fixed rate individual income tax cuts (3.3 trillion yen, USD 28 billion, or 0.7 percent of GDP) by 50 percent. This year's plan is to eliminate the cuts entirely.

Tax incentive programs for corporate investment and research and development will be eliminated as scheduled in March 2006 but some tax incentives will be created for corporate investment in advanced software. The tax reform will also transfer 3 trillion yen (USD 26 billion) in tax collection authority to local governments by changing tax rate structures.

15. (SBU) A proposal to simplify liquor taxes by reducing the number of categories of liquor will marginally increase the price of wine by about 10 yen per bottle but the impact of the marginal increase this year on U.S. imports is expected to be small. Tobacco taxes will increase by about 20 yen per pack. The tax legislation will also change the definition of non-permanent residents, making it clear that any person living in Japan for a period of more than five years within any ten-year period cannot claim non-permanent residence status and must be considered a resident for tax purposes. This will undoubtedly affect foreign company personnel decisions regarding length of stay of expatriate employees in Japan.

16. (SBU) Although there has been discussion in the press about an "environment tax" on fossil fuels as a measure to help control Japan's greenhouse gas emissions that contribute to global warming, the Environment Ministry has decided not to press for this tax before the end of FY 2005. Environment Ministry contacts expect, however, that it is likely they will propose this tax to the Diet next year.

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Health Care

17. (SBU) The health care reform bills seek to head off drastic increases in health care spending but represent only modest steps toward addressing the misallocation of health care resources, a missed opportunity to promote competition and investment in the medical services market and an indication of continuing pressure to cut reimbursements for medical devices and pharmaceuticals. The Ministry of Health, Labor, and Welfare (MHLW) will propose amendments to the Medical Law aimed at increasing financial transparency in medical corporations and reinforcing non-profit healthcare. Rather than opening the medical services market to for-profit enterprises (an issue we have raised in bilateral investment talks), the MHLW proposals seek to address local shortages of pediatric and other emergency care by offering tax breaks and flexibility to develop alternative sources of revenue for private hospitals that accept an obligation to provide such services under a new non-profit "social-medical corporation" form. Alternative revenue sources for social-medical corporations are to include profit-oriented activities such as nursing home and child care services, the proceeds of which could be used to make up for thin margins on emergency care but not distributed to investors. The proposal also will relax restrictions on issuance of hospital bonds by social-medical corporations. Left essentially untouched by these proposals is the vast majority of small private hospitals and clinics that account for much of the overcapacity and inefficiency in the Japanese health care system.

18. (SBU) A bill to amend the Health Insurance Law will increase co-payments for relatively wealthy seniors in order to reduce projected increases in health care spending driven by the aging of Japanese society. The bill will seek further

savings through adjustments to the reimbursement model designed to reduce incentives for doctors to over-prescribe treatments. Additional provisions would shift responsibility for managing public insurance plans to the local level, a move that many local officials oppose.

¶9. (SBU) MHLW also will submit an amendment to the Pharmaceuticals Law to revise regulations on the retail sale of over-the-counter drugs for the first time since the current system was introduced in 1960. It is not yet clear whether the new rules will allow for Internet retailing of low risk drugs, a topic of hot debate among businesses and consumers.

Securities Exchange Law (SEL)

¶10. (SBU) A bill to revise tender offer bid (TOB) rules closes loopholes exploited in several high profile corporate takeover attempts last year while also increasing the transparency of the TOB process and allowing withdrawal or modification of offers when target firms deploy certain defensive measures. The new rules, to be submitted by the Financial Services Agency (FSA), also will require target company boards to take a formal position on TOBs and communicate their views to shareholders. Details have not yet been finalized, but the new rules could contribute to improving corporate governance if written so as to limit the use of takeover defenses deployed to protect entrenched management. The FSA is also expected to propose more frequent reporting by shareholders possessing more than 5 percent of a given firm's outstanding shares, a requirement that would interfere with the legitimate investment strategies of institutional investors and private funds.

Agricultural Reform

¶11. (SBU) Agricultural issues are back in the spotlight because of the flap over beef, but we anticipate that the Diet debate will focus on bills on agricultural reform. The bills on the docket constitute a real, if less than sweeping, effort to change Japan's subsidy system to raise efficiency. They would modify domestic subsidies to improve competitiveness in an environment of increased imports after the conclusion of the Doha Round of World Trade Organization

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(WTO) talks. The government intends to shift away from conventional price subsidies toward cross commodity payments that would be limited to farms and farming institutions that have demonstrated an ability to revitalize the industry. Only farms and farming institutions that exceed the defined criteria would receive the payments. The ministry hopes the new bill will encourage farmers to consolidate farmland and thus increase competitiveness. This modest bill should be submitted to the Diet at the end of February. We do not expect it to lead to any significant reform of the agriculture sector.

Town Planning Laws (Machizukuri Sanpo)

¶12. (SBU) The government's bill to revise the Town Planning Laws represents a step back from reform, albeit not as bad as we had initially heard thanks to energetic lobbying by Japanese business to roll back the worst provisions of this draft legislation. If passed the bills would restrict the opening of new stores over 10,000 square meters. In order to attract retailers back into traditional urban commercial centers, the Ministry of Land, Infrastructure, and Transport (MLIT) will submit amendments to the City Planning Law that reduce from six to three the types of zoned property on which retailers will be able to open new stores of over 10,000 square meters. To further sweeten the pot for retailers to move back downtown, MLIT and the Ministry of Economy, Trade and Industry will also introduce amendments to the Urban Center Revitalization Law that will simplify procedures and offer extra incentives for opening new retail stores in

"hollowed-out" urban shopping districts. The Japan Chain Store Association -- the large-scale retailing industry's main trade group -- opposes the amendments, and the private-sector members of the Cabinet's CEFP have also expressed their concern that the proposed changes would do little to address the problems facing urban shopping areas and would reverse the Koizumi administration's regulatory reform policies. Since the GOJ announced plans for these revisions in summer 2005, embassy economic officers have visited MLIT on a number of occasions to outline our concerns that the changes will be overly restrictive toward large retailers. In addition, AUSTR Wendy Cutler raised the issue during the November US-Japan Trade Forum in Seattle, and we also included concerns about the proposed revisions in this year's Regulatory Reform Initiative recommendations and negotiations.

Employment Practices

¶13. (SBU) A preliminary government census indicates that Japan's total population, including foreign residents, may have decreased in 2005 for the first time since the end of WWII, heightening the importance of government measures to increase the number of workers by expanding employment opportunities for youth, women and senior citizens, especially as baby boomers near retirement. The MHLW intends to submit the following bills to address this situation:

¶14. (SBU) The Equal Employment Opportunity and Labor Standard Amendment Bill: This bill would further reduce gender discrimination, prohibit disadvantageous treatment of woman workers because of pregnancy, and relax regulations that prohibit women from working in mines. A ministerial order would prohibit implicit gender discriminations such as recruitment based on height and weight where there is no explicit job requirement thereof. In addition, the number of transfers to different posts within a company would become an included criterion for promotion. Although it is already illegal to fire an employee due to pregnancy, a new amendment would also outlaw other discriminatory treatment such as a mandatory transfer to a different department or line of work.

¶15. (SBU) Human Resource Development and Employment Management Amendment Bill: This bill would provide practical, effective, vocational training for youths by establishing a new system that combines on-the-job training (OJT) with lectures. The system would allow young workers to receive OJT at private firms for a defined period, as well as attend lectures at educational institutions, while still being paid.

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The goal is to help retiring baby boomers to transfer their technical skills and know-how to young people. The number of young unemployed people, including freeters (&intermittently employed8) and NEET (~ in employment, education or training8), now stands at four million.

Market Testing

¶16. (SBU) The Cabinet Office will submit a draft law on market testing -- the outsourcing to private-sector entities of a limited number of government services -- in early February for consideration in conjunction with the budget bill. The proposed law, tentatively titled the "Bill for the Reform of Public Services through the Introduction of Competition," would amend laws and procedures to allow the private sector to bid competitively with the public sector to provide public services on the national and local levels. The bill probably will not specify public services that the private sector will be allowed to bid on, but will instead contain a provision for determining appropriate areas for applying market testing. (See Ref B)

Customs Law

¶17. (SBU) The Ministry of Finance (MOF) plans to introduce a

bill that would revise the Customs Law to require all aircraft and ships to submit detailed information on passengers and cargo prior to the vessel's arrival in Japan. MOF held a public comment period on the bill during November 9-18 and is now drafting details of the law. MOF's plan would require aircraft and vessel captains to submit the necessary information, but the Ministry is considering broadening reporting authority to allow prior notification by a broader range of authorized reporters, echoing a request that the USG made in this year's Regulatory Reform Initiative recommendations to the GOJ.

Road Transportation Vehicle Law

¶18. (SBU) MLIT plans to submit a bill to revise the Road Transportation Vehicle Law in order to reduce the burden on auto leasing companies and other owners of large numbers of vehicles when they change registration information and transfer titles. MLIT plans to remove owners' information from the original certificates of vehicle inspection so that new owners will not have to submit the inspection certificate for changes in registration and title transfers, a process that currently deprives lessees of the use of the vehicle during the transition period. The revision would also include measures to facilitate on-line application for these changes. The USG has advocated this issue both in our annual regulatory reform talks and through the Office of the Trade Ombudsman and we are pleased that MLIT is taking these steps to ease the burden on fleet vehicle owners. However, we believe the revisions do not go far enough since the law will still require owners to complete registration procedures within an unreasonable 15-day time period.

Anti-Corruption Legislation

¶19. (SBU) The Diet will take up the ratification of the United Nations Anti-Corruption Convention at the beginning of March according to the current agenda. Interestingly, however, proposed legislation on combating organized crime, which includes a provision applying penalties for acts of bribery undertaken by Japanese nationals overseas that would bring Japan into accord with the OECD anti-corruption guidelines, continues to remain "under consideration" as it has been since it was originally submitted in 2004. The agenda contains no scheduled time for that bill's reconsideration.

Eliminating Tariffs on Multi-chip Integrated Circuits

¶20. (SBU) This multilateral treaty between the United States, EU, Korea, Taiwan and Japan will eliminate tariffs on multi-chip integrated circuits, with the hope of spurring other zero-tariff sectoral agreements in WTO negotiations. Under the agreement, the U.S. will abolish its 2.6 percent

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duty, the EU its duties ranging up to 4 percent and Korea its 8 percent duty. Japan will keep its existing rate at zero. The treaty should be submitted to the Diet end February.

MRA on Telecommunications Equipment

¶21. (SBU) U.S. and Japanese negotiators are finalizing the text of a Mutual Recognition Agreement (MRA), the first MRA between the U.S. and Japan. The agreement will allow U.S. and Japanese regulators to accept the results of testing labs and certifications on telecommunications equipment obtained in the other country leading to easier market access for manufacturers on both sides. Japan is interested in expanding the agreement or using it as a model to cover other kinds of goods such as medical equipment. U.S. testing labs are especially interested in the agreement. The Ministry of Foreign Affairs (MOFA) expects the Cabinet to submit the MRA to the Diet during this session, but the timing is unclear.

Free Trade Agreements (FTAs)

¶22. (SBU) Only the "economic partnership agreement" with Malaysia, signed on the fringes of the East Asia Summit in December, has formally made the Diet's agenda, scheduled for the last 10 days of February. In addition, an amendment to apply the same certificates of origin provisions to Malaysian products that the Japan-Mexico FTA offers will also be considered, along with changes to Japan's tariff schedule. According to contacts at MOFA, the Government is still hoping to submit the draft agreement with Thailand and possibly the agreement under negotiation with the Philippines. (Both agreements are listed on the schedule for this session as "items under discussion outside the submitted agenda.")

What's Missing?

¶23. (SBU) In addition to the bills and treaties above, it is important to note that the government has not submitted any revision of Company Law Article 821 to eliminate legal risk for foreign firms that conduct their primary business through their branches in Japan. The LDP leadership reportedly has rejected a request from an individual LDP Diet member to table an amendment during this session, before the Company Law enters into force in May, calculating that an admission of error would only offer the DPJ more ammunition with which to attack the government for past mistakes. While the Diet member in question has suggested that it may be possible to amend Article 821 in the fall 2006 session, the prospects for this are uncertain at best; we expect a new Prime Minister to be in place and he too may be unwilling to risk embarrassment over Article 821.

Conclusion

¶24. (SBU) Koizumi has ambitiously set out to further his reform agenda in this Diet session with his administrative reform bill. Some of the other bills in the docket are less ambitious, however, such as the health care amendments, agricultural subsidy revisions, and changes to the Town Planning Laws, an indication that the Prime Minister's commitment to reform does not cross all sectors. Nevertheless, the outlook for continued, if watered-down, reform remains good.
SCHIEFFER